89-1832

No. .....

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

HEALTHCARE INTERNATIONAL, INC., WEST OAKS, INC., HEALTHCARE-BROWN MANAGEMENT CO., THE BROWN SCHOOLS, INC., JAMES L. FARISS, JR., DAVID L. WHELAN, AND ELLIOTT H. WEIR, JR.,
Petitioners,

v.

L & B HOSPITAL VENTURES, INC., LEO J. BORRELL, BOBBY R. LOWRANCE, PSYCHIATRIC ASSOCIATES OF HOUSTON, P.A., AND DOUGLAS B. HANSEN,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether an investor who has significant input into the day-to-day operations of a partnership may claim that his or her interest is an "investment contract" under the test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), which requires that the investor have an expectation of profits derived "solely from the efforts of the promotor."

2. Whether an investor who makes an undeniably significant contribution to the profitability and success of a partnership may claim that his partnership interest is an "investment contract."

3. Whether an investor in a partnership who, in economic reality, makes an undeniably significant contribution to the profit or loss of the partnership, is the owner of a "security" simply because the partnership agreement is labelled a "limited partnership agreement" and purports to limit the investor's control over the management of the partnership.

4. Whether the originator, developer and seller of an investment who retains an interest in the venture thereafter has a "security."

5. Under *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986), may a party with the burden to prove his or her partnership interest is a "security" avoid summary judgment where the summary judgment evidence regarding his or her substantial involvement in the partnership's business is not disputed?

RULE 28.1 LIST

Pursuant to Supreme Court Rule 28.1(b), the following is a list of all parties to the proceedings below:

1. L&B Hospital Ventures, Inc., Plaintiff.
2. Leo J. Borrell, Plaintiff.
3. Bobby R. Lowrance, Plaintiff.
4. Psychiatric Associates of Houston, P.A., Plaintiff.
5. Douglas B. Hansen, Plaintiff.
6. Healthcare International, Inc., Defendant.
7. West Oaks, Inc., Defendant.
8. Healthcare-Brown Management Co., Defendant.
9. The Brown Schools, Inc., Defendant.
10. James L. Fariss, Jr., Defendant.
11. David L. Whelan, Defendant.
12. Elliott H. Weir, Jr., Defendant.
13. William H. Boylston, Third-Party Defendant.
14. Jules H. Bohn, Third-Party Defendant.
15. Peter A. Olsson, Third-Party Defendant.
16. Ramesh R. Parikh, Third-Party Defendant.
17. V. Thomas Lankford, Jr. and Paul V. Castellitto, of the firm of Sharp, Green & Lankford, attorneys for Plaintiffs.
18. Philip P. Sudan, Jr., of the firm of Ryan, Shoss, Sudan & Lawley, attorneys for Plaintiffs.
19. Robin C. Gibbs, Robert N. Brailas, and Jeffrey C. Alexander of the firm of Gibbs & Ratliff, attorneys for Defendants and Third-Party Plaintiffs.

TABLE OF CONTENTS

	PAGE
QUESTIONS PRESENTED	i
RULE 28.1 LIST	ii
TABLE OF CONTENTS	iii
TABLE OF AUTHORITIES	v
OPINIONS BELOW	1
JURISDICTION	1
STATUTORY PROVISIONS	2
STATEMENT OF THE CASE	2
I. Overview	2
II. Factual Background	3
A. The Doctors Originally Promoted the Venture	3
B. The Doctors Had Significant Input into and Control of the Hospital's Daily Operations	5
C. The Doctors Made Undeniably Significant Contributions to the Venture's Success	9
REASONS FOR GRANTING THE WRIT	11
I. The Court of Appeals' Decision Conflicts with This Court's Prior Decisions	11
1. The "Managerial Efforts" Test Adopted by the Court of Appeals Conflicts with This Court's Prior Decisions	11
2. The Promoter of a Venture Cannot Assert That His or Her Interest Is a "Security"	15
3. The Court of Appeals' Decision Is Contrary to the Summary Judgment Principles Set Forth in *Celotex*	16

PAGE

II. The Court of Appeals' Decision Conflicts with Other Federal Courts' Rulings 21

1. Other Federal Courts Recognize That an Investor Who Contributes Substantially to the Success of a Partnership May Not Assert Securities Claims 21

2. Other Federal Courts Have Rejected the "Managerial Efforts" Test Adopted by the Court of Appeals 21

3. The Court of Appeals' Decision Conflicts with the "Undeniably Significant Efforts" Test Utilized by Other Federal Courts 25

CONCLUSION 29

APPENDIX

1. Court of Appeals' Opinion A1
2. District Court's Final Judgment A9
3. District Court's Opinion A10

TABLE OF AUTHORITIES

PAGE

Cases:

Albanese v. Florida National Bank, 823 F.2d 408 (11th Cir. 1987) 17, 21

Bailey v. J.W.K. Properties, Inc., 703 F. Supp. 478 (W.D. Va. 1989) 14, 18, 19, 26

Bamco 18 v. Reeves, 675 F. Supp. 826 (S.D.N.Y. 1987) 14, 18

Bank of America National Trust & Savings Ass'n v. Hotel Rittenhouse Assocs., 595 F. Supp. 800 (E.D. Pa. 1984) 14, 15

Bender v. Continental Towers Limited Partnership, 632 F. Supp. 497 (S.D.N.Y. 1986) 21, 25, 26

Celotex Corp. v. Catrett, 477 U.S. 317 (1986) ..... i, 3, 16-19

Crowley v. Montgomery Ward & Co., 570 F.2d 877 (10th Cir. 1978) 13, 18, 27-28

Deutsch Energy Co. v. Mazur, 813 F.2d 1567 (9th Cir. 1987) ... 27

Dumbarton Condominium Ass'n v. 3120 R Street Associates Limited Partnership, 657 F. Supp. 226 (D.D.C. 1987) 26

Fargo Partners v. Dain Corp., 540 F.2d 912 (8th Cir. 1976) .. 18, 26

Frazier v. Manson, 651 F.2d 1078 (5th Cir. 1981) .. 13, 14, 15, 17, 18

Goodwin v. Elkins & Co., 730 F.2d 99 (3d Cir.), *cert. denied*, 469 U.S. 831 (1986) 27

Gordon v. Terry, 684 F.2d 736 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983) 13, 14, 17, 21, 27

Grenader v. Spitz, 537 F.2d 612 (2d Cir.), *cert. denied*, 429 U.S. 1009 (1976) 25

Inforex Corp. v. MGM/UA Entertainment Co., 608 F. Supp. 129 (C.D. Cal. 1984) 18, 23, 24, 25

Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) 15

Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973) 27

Marine Bank v. Weaver, 455 U.S. 551 (1982) 12, 15, 18

Maritan v. Birmingham Properties, 875 F.2d 1451 (10th Cir. 1989) 13, 18, 23-24, 25

Martin v. T.V. Tempo, Inc., 628 F.2d 887 (5th Cir. 1980) 13, 17, 21, 23

PAGE

Meyer v. Dans un Jardin, S.A., 816 F.2d 533 (10th Cir. 1987) 18, 26-27

Reves v. Ernst & Young, 58 U.S.L.W. 4208 (1990) 15, 16

Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236 (4th Cir. 1988) 18, 26

SEC v. W.J. Howey Co., 328 U.S. 293 (1946) ..... passim

SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974) 12

SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) 12

Slevin v. Pedersen Associates, Inc., 540 F. Supp. 437 (S.D.N.Y. 1982) 13, 23

Tcherepnin v. Knight, 389 U.S. 332 (1967) 14, 29

United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) 11, 12, 14, 18

Villenueve v. Advanced Business Concepts Corp., 698 F.2d 1121 (11th Cir. 1983), *aff'd en banc per curiam*, 730 F.2d 1403 (1984) 12, 13, 18, 27

Williamson v. Tucker, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981) 21-22, 27

STATUTORY PROVISIONS AND PROCEDURAL RULES

Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j 1

Securities Exchange Act of 1934, §§ 13, 15 U.S.C. § 78c 2, 11

Securities Exchange Rule 10b-5, 17 C.F.R. 240.10b-5 1

28 U.S.C. § 1254(1) 1

COURT RULES

Fed. R. Civ. P. 1 17

Fed. R. Civ. P. 56 ..... 3, 17

Supreme Court Rule 28.1 ii

Supreme Court Rule 19.1 4

OTHER AUTHORITIES

Loss, *Fundamentals of Securities Regulation* 14

To the Honorable Chief Justice and the Associate Justices of the Supreme Court of the United States of America:

Petitioners Healthcare International, Inc. ("Healthcare"), West Oaks, Inc., Healthcare-Brown Management Co., The Brown Schools, Inc., James L. Fariss, Jr., David L. Whelan, and Elliott H. Weir, Jr., respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 894 F.2d 150, and is reprinted in the appendix attached hereto, p. A1. The opinion of the United States District Court for the Southern District of Texas, Houston Division is not reported and is reprinted in the appendix attached, p. A10.

JURISDICTION

This suit was originally filed asserting claims under section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5. On February 2, 1989, the District Court signed an order granting summary judgment against Plaintiffs on their claims under federal securities laws, which was entered of record on February 5, 1989. On February 2, 1989, the District Court entered an order finally disposing of all claims. This order was entered of record on February 6, 1989. On February 12, 1990, a panel of the Fifth Circuit reversed the District Court's judgment, and on March 26, 1990, the Fifth Circuit denied Petitioner's suggestion for rehearing *en banc*. Jurisdiction of this matter is proper pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

15 U.S.C. § 78c. Definitions and application

(a) When used in this chapter, unless the context otherwise requires — . . . .

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

STATEMENT OF THE CASE

I. Overview

This case raises important issues regarding the scope of the federal securities laws in cases where the investor seeks to assert that his interest in a partnership venture is an "investment contract." In particular, this case raises important and recurring questions as to whether merely labelling an investment a "limited partnership" and purporting to limit the investors' role in formal legal documents renders the investment a "security," subject to the formidable regulatory scheme of the federal securities statutes.

In *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), this Court held that in order to qualify as an investment contract, a transaction must be one in which a person "invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . ." *Id.* at 299. The Fifth Circuit held in this case that the only "*managerial efforts*" need be considered in applying this test. App. at A6; 894 F.2d at 152 (emphasis in original). Thus, despite voluminous and undisputed evidence showing beyond question that the Plaintiffs in this case had substantial input into the venture's operations and were the key factor in the venture's economic success, the Court of Appeals found that a fact issue existed as to the allocation of "managerial" control.

Additionally, this case raises fundamental questions regarding the interplay between the standard for granting summary judgment under Fed. R. Civ. P. 56 and the test for whether a partnership interest is an investment contract. Under *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986), the Plaintiff-Doctors, who have the burden of proving their partnership interests were "securities," were required to raise a fact issue on every element of the *Howey* test. They failed to controvert the specific instances of substantial participation in the venture established by Petitioners in their summary judgment motion. Thus, they failed to raise an issue as to whether they substantially participated in the venture's operations.

II. Factual Background

A. The Doctors Originally Promoted the Venture

The evidence adduced in this case established that Dr. Leo Borrell, Dr. Bobby Lowrance and Dr. Douglas Hansen (the "Plaintiff-Doctors"), along with Dr. Edwards U. McReynolds, a principal in Plaintiff Psychiatric Associates of Houston, P.A. ("PAH"), correctly characterized themselves as the "Founding

Fathers" of the West Oaks Hospital.[1] R. 687, 738-39.[2] Beginning in 1976 or 1977, these four doctors undertook to develop a new hospital, which they intended to own and to which they would admit their patients. R. 716-17, 779, 787-88. Plaintiffs intended to develop and implement their programs at the hospital for treatment of children and adolescents. R. 687-88, 723-26, 779, 831-33. They hired their own business consultant and attorneys, and filed their own certificate of need application for the project as then required by state law. R. 688, 723-26, 741-76, 784, 813, 832-33. They personally invested some $120,000 in promotional expenses for the project before Petitioners entered the picture. R. 739. The original plans for the hospital were initiated in the period 1976 through June 1979, prior to any involvement by Petitioners. R. 687, 713-15, 787-88, 812-20, 831-33.

Plaintiffs (sometimes referred to as "the Doctors") then negotiated with several national healthcare companies to provide administrative and financial support. R. 688, 721-22, 779-80, 814-16, 833-35. In mid-1979, when negotiations with other companies broke down, the Doctors approached The Brown Schools, Inc. ("Brown Schools"), later a subsidiary of Petitioner Healthcare International, Inc. to join in the hospital venture. On June 19, 1979, an agreement was reached whereby the doctors retained a 25% ownership interest in the hospital project and conveyed a 75% interest to Brown Schools under a limited partnership arrangement. Brown Schools was to hold its 75% interest as a general partner and Lowrance, Borrell, Hansen and

---

[1] The only other Plaintiff, L&B Hospital Ventures, Inc., is a corporate entity owned by Lowrance and Borrell.

[2] Because this case involves the application of summary judgment standards to the evidence in this case, Petitioners respectfully recommend certification of the record to the Court. Sup. Ct. Rule 19.1. References to the record shall be by page number in the record transmitted to the Court of Appeals. For example, page 600 of the Record shall be cited as "R. 600."

PAH would hold equal "limited partnership" shares of 6.25% each. R. 689, 731-32, 819-21, 822-24, 838-39. Brown Schools was to provide administrative services to the hospital and arrange financing for construction and operation of the hospital. R. 689, 779-81, 836, 929-30. However, the letter of intent signed by the parties expressly provided that "[the Doctors] shall have the right to review and approve the hiring of the medical director, and an appropriate joint committee will be formed with the Doctors as members for discussion of mutual concerns." R. 823.

When the Doctors decided to terminate their relationship with Healthcare, they negotiated to purchase Healthcare's 75% interest. R. 803-04, 867-68, 73-75. Failing in that effort, they sold their interests to Healthcare and used the proceeds to construct a competing hospital. R. 803-04, 867-68, 805-09, 852-60. They subsequently brought this suit, asserting that in purchasing their limited partnership interests Healthcare had concealed material information regarding the value of the hospital. Healthcare counterclaimed, alleging that the Doctors had failed to reveal their plans to open a competing facility. After substantial discovery, the District Court held that the Doctors' substantial participation in and control over the success of the hospital precluded their securities claims as a matter of law. Healthcare's claims against the Doctors and the Doctors' state-law claims against Healthcare are the subject of a pending action in Texas state court.

B. The Doctors Had Significant Input into and Control of the Hospital's Daily Operations

The summary judgment evidence submitted to the trial court established as a matter of law that the Plaintiff-Doctors had substantial input into the daily operations of the hospital. Most of that evidence consisted of the Doctors' own sworn deposition testimony regarding the importance of their contributions to the continued operation and success of the venture. For example,

Plaintiffs confirmed in their depositions their active participation in hospital staff education, program design and development, physical structural design, personnel evaluation, transfer and admission of patients, sharing of patients and third-party insurance information. R. 729-30, 788, 794-97, 842, 932-33, 936-38, 940. Dr. Lowrance described their ongoing involvement in the affairs of the hospital as follows:

> Q: And would you tell us the ways in which you and the rest of the limited partner doctors involved yourself in the ongoing operations of the Hospital after it opened?
>
> A: Establishing a medical staff and the allied health professional staff, the setting up of medical staff committees. We chaired most of those committees. We were active in the Medical Staff Executive Committee, and had an active role in the recruitment of physicians to practice at the hospital and allied health professionals, and assisted the hospital in developing an excellent reputation for high quality medical staff and allied health professional staff and high quality patient care. We developed the children's program and employed child psychiatrists to run that program. We actively participated with the hospital in continuing education and development of an ongoing continuing education program both for the general public as well as for the professional community, both within and outside the hospital. We also worked with the hospital around issues about marketing of the hospital and the hospital programs.

R. 843-44.

The Doctors also entered into a number of contracts with the hospital under which they rendered vital operational services to the venture. They provided a host of services under a "Clinical Advisory Agreement," which Dr. McReynolds testified was "seen probably as the seat of power in the hospital." R. 729-90, 840, 907-26, 932-34, 940, 947-48. The Doctors formed Psychiatric Hospital Consultants of Houston, Inc. to be the "Advisor" under

the Clinical Advisory Agreement. The Agreement expressly provided that the hospital would not:

> (i) institute, terminate or change in any material respect any Hospital clinical program, or (ii) terminate or change in any material respect the authority or duties of the Medical Director, as set forth in Attachment I, except in good faith and unless Hospital gives Advisor 90 days' prior written notice thereof and affords Advisor a reasonable opportunity to discuss any such institution, termination or change with the General Partner or its designated governing body of the Hospital.

R. 909. By virtue of their service on the Clinical Advisory Committee and Credentials Committee, the Doctors were empowered to (1) hire and fire the medical director, and (2) control whether other doctors and health professionals practiced at the hospital. R. 947-48.

The Doctors also provided services under the Children's Programs Clinical Agreement, R. 840-41, 917-25, and further served as unit medical directors for certain hospital units. Dr. McReynolds described the authority and responsibilities of the unit medical directors as follows:

> Essentially *captain of the ship.* We were responsible for delivery of care. We had administrative assistants who took care of the nuts and bolts, attendance and interviewing. But all the staff direction and staff supervision, staff education, we were the cheerleaders of the unit and clinical directors.

R. 932 (emphasis added). In this capacity, Plaintiffs provided staff direction, supervision and education and shared with Healthcare representatives responsibility for hiring and firing of staff. R. 932-33, 947.

Dr. Hansen served as Medical Director of the hospital and in that capacity was responsible for overseeing the medical and clinical aspects of the hospital, including directing and coordinating all psychiatric and medical activities, supervising the medical

staff, developing organizational plans, advising the hospital administrator with regard to problem employees and on questions of policy, advising the medical staff on medical and administrative problems, and numerous other responsibilities. R. 796, 946-47, 949-60. At the inception of the partnership, Dr. Hansen signed a five-year agreement to serve as manager of the children's program at the hospital. R. 917, 925. The agreement required the hospital to cooperate with the manager, R. 920, and authorized the manager to provide or cause to be provided physician and professional services necessary to operate the children's program. R. 918.

As unit medical directors, the Doctors sat on the hospital's executive committee and participated in review and approval of all clinical business of the hospital. Similarly, they often chaired the Hospital Credentials Committee and the Continuing Education Committee. R. 933-38. Dr. Borrell testified that Plaintiffs had substantial responsibility for promoting the venture to the general public and in recruiting new doctors to practice at the hospital. R. 794-95.

In addition to Plaintiffs' own testimony, Petitioner submitted the Affidavit of Kay Peck, R. 946-60, which stated that:

1. The Medical Director of West Oaks (Dr. Hansen) had considerable power over the daily operations of the hospital (citing 15 specific examples of control);

2. The Doctors served as unit medical directors, giving them powers akin to that of the Medical Director within their specified programs;

3. Under the Clinical Advisory Agreement, the Doctors had substantial input into and control over the development and termination of the hospital's clinical programs, which controlled literally every patient bed in the hospital; and

4. The Doctors controlled the "credentialing" of doctors and thus controlled who could admit patients to the hospital.

No affidavit or other evidence was adduced by Plaintiffs to contradict or deny these statements. Plaintiffs instead labelled their indisputably critical contributions "clinical" and asserted they were outside the scope of the *Howey* test. They also argued that because some of the formal legal documents signed at the inception of the partnership labelled their interests "limited partnership" interests and contained boilerplate language purporting to limit their authority, their interests were securities regardless of the degree of control they actually possessed.

C. The Doctors Made Undeniably Significant Contributions to the Venture's Success

The undisputed summary judgment evidence shows that the Doctors' contributions were vital to the hospital's success. As the trial court found, and as the Doctors themselves admitted, a hospital is "doctor driven." App. at A14; R. 728. The summary judgment evidence was again based largely on Plaintiffs' admissions.

For example, Dr. McReynolds testified that the Doctors admitted 75% to 90% of the hospital's patients during the early years of the hospital, and contributed 50% to 65% of the patients thereafter. R. 931. He agreed that "most of the revenues that were generated up through the end of 1985 for the hospital came from the partner-doctor referrals." R. 941. He expressed the following view of the Doctors' contributions to the hospital enterprise:

> Q: Would you agree that the partner-doctors, over the years prior to the sale of their partnership interest, *both in terms of their contribution to revenue and in the contribution to management of the operations of the hospital, contributed substantially to the profitability of the hospital?*
>
> A: Certainly.

R. 937-38 (emphasis added).

Dr. Lowrance similarly testified in deposition that Plaintiffs *definitely* "contributed very substantially to the profitability which this hospital experienced once it opened its doors." R. 845. Dr. Borrell testified that at first the Plaintiff-Doctors contributed 70% to 80% of the admissions and later, after hospital expansion, 40% to 70% of the hospital's patients. R. 789-90. He enumerated the Doctors' contributions to the "success," "substantial value" and "profitability of the partnership" in his deposition. R. 791-95. In his deposition, Dr. Borrell agreed that the "profitability or failure of the venture . . . was in large part relying on you Doctors' performance. . . ." R. 800-01.

Finally, Dr. Hansen testified that the Doctors were "substantial contributors to the admissions of patients . . . and therefore were a substantial contributor to the profitability of the hospital." R. 740. Dr. Hansen testified that the Plaintiffs were "very important" to the operation, success and profitability of the hospital. R. 729.

The importance of patient admissions to the success of any hospital cannot be overstated. As Dr. Hansen put it, "obviously, any hospital rises or falls on doctors. If they don't have any patients to admit . . . then the hospital fails." R. 728. He later compared the Doctors' influence to that of a "rainmaker" at a law firm:

Q. Tell us how your influence over hospital admissions would give you leverage with Healthcare.

A. Well, it's like your law firm: If one of the partners is bringing in a great number of — a substantial proportion of your business, you tend to listen to what he has to say.

Q. That's because the lifeblood of a hospital was the admission of the patients, in terms of revenues?

A. The lifeblood of a hospital is admissions, any hospital.

R. 733-34.

REASONS FOR GRANTING THE WRIT

I. The Court of Appeals' Decision Conflicts with This Court's Prior Decisions

1. The "Managerial Efforts" Test Adopted by the Court of Appeals Conflicts with This Court's Prior Decisions

This case involves the application of federal securities statutes to the partnership interests retained by the Plaintiff-Doctors when they sold Healthcare International a 75% general partnership interest in a Houston-area hospital. It was undisputed, both in the trial court and in the Court of Appeals, that the partnership interests could be considered "securities" only if they were "investment contracts." 15 U.S.C. § 78c(a)(10) (defining "security" for purposes of the Securities Exchange Act of 1934).

The Supreme Court first defined the term "investment contract" in the seminal case *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). In that case, the Court held:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.

Id. at 298-99. The Court thus established three elements that must exist before an interest in a business venture may properly be characterized a "security": (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits derived solely from the efforts of others. If any one of these elements is absent there is no "security" under federal securities laws. *E.g., United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (where investor failed to show expectation of profits, no security existed).

The third prong of *Howey* has spawned much litigation since this Court first penned it. It has been widely perceived that the

Court did not intend the language to be applied literally. Thus, the Ninth and Fifth Circuits adopted a more expansive test:

> Strict interpretation of the requirement that profits be earned "solely" from the efforts of others has been subject to criticism. . . . [W]e adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.

SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *see also, SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (adopting rule of *Glenn W. Turner Enterprises*). This Court has reserved opinion on the validity of this interpretation of *Howey*. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 n.16 (1975); *see also Villenueve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124-25 (11th Cir. 1983), *aff'd en banc per curiam*, 730 F.2d 1403 (1984) (noting potential for conflict between *Koscot* and *Howey* and reserving question.)

In this case the Fifth Circuit has fundamentally altered the nature of the *Howey* test even beyond the liberal interpretation adopted by the Ninth Circuit. Despite overwhelming and undisputed evidence that the Plaintiff-Doctors had substantial day-to-day participation in and control over the hospital's operations, the Court of Appeals held that those efforts were irrelevant because they were not "managerial." App. at A5, A6. The Court of Appeals did not explain what constitutes "managerial" efforts, nor did it explain in what sense the Doctors' efforts did not meet this test. The test adopted is an unprecedented expansion of the definition of an "investment contract," and conflicts with this Court's admonition that the federal securities acts "[do] not . . . provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

This Court may not have intended for the third prong of the *Howey* test to be applied literally. Petitioners believe, however, that the Court intended in *Howey* to exclude from the ambit of the securities laws situations where, as here, an investor is actively involved in the day-to-day operations of a venture and substantially contributes to its success and profitability. *E.g., Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Villenueve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124-25 (11th Cir. 1983), *aff'd en banc per curiam*, 730 F.2d 1403 (1984); *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981); *Martin v. T.V. Tempo, Inc.*, 628 F.2d 887 (5th Cir. 1980); *Crowley v. Montgomery Ward & Co.*, 570 F.2d 877, 880-81 (10th Cir. 1978); *Slevin v. Pedersen Associates, Inc.*, 540 F. Supp. 437 (S.D.N.Y. 1982). The Plaintiff-Doctors cited no case — and Healthcare is aware of none — where the founder, promoter and key "rainmaker" of a partnership successfully asserted that his or her interest in the partnership was a "security." The Court of Appeals' decision alters this *Howey* principle, holding that so long as a party may label his or her contributions as something other than "managerial" efforts, those efforts cannot be considered in applying *Howey* regardless of how important they were to the success of the enterprise.[3]

Furthermore, the Court of Appeals relied heavily on the fact that the Doctors' interests were called "limited partnership"

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[3] The distinction between "managerial" and "clinical" efforts is far from clear. The entire business of a hospital is the provision of clinical services to patients. The Plaintiff-Doctors were by their own admission involved in staff decisions, resource allocation, purchasing and other ostensibly "managerial" functions. If the Fifth Circuit's "managerial" versus "clinical" distinction is upheld, one can foresee a multitude of other distinctions being offered, as investors claim their contributions were "operational," "supervisory," "advisory," "promotional," or any one of hundreds of other labels clever attorneys can dream up to avoid the clear dictates of *Howey* that substantial participation in the enterprise takes the interest outside the federal securities laws.

interests and on formal recitations in the partnership agreement. App. at A6-A7. In doing so, the Court of Appeals strayed from the fundamental principle that in applying the *Howey* test, "form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). Thus, regardless of the label placed on the interest, it is not an "investment contract" unless it meets the *Howey* test. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). It has been recognized by other federal courts that limited partnership interests are not inherently "securities." *See, e.g., Gordon v. Terry*, 684 F.2d 736, 741 n.5 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981); *Bailey v. J.W.K. Properties, Inc.*, 703 F. Supp. 478 (W.D. Va. 1989); *Bamco 18 v. Reeves*, 675 F. Supp. 826 (S.D.N.Y. 1987); *Bank of America National Trust & Savings Ass'n v. Hotel Rittenhouse Assocs.*, 595 F. Supp. 800 (E.D. Pa. 1984).

As Professor Loss has noted:

> Interests in partnerships may be securities. . . . The problem, as Judge Frank put it when he was Chairman of the SEC, is to distinguish between the public offering of securities parading as "limited partnership interests" and "an offering of a half-interest in a hamburger stand."

Loss, *Fundamentals of Securities Regulation*, 198-99 (1983).

The factors used by courts in determining whether a limited partnership interest is a security all suggest that the interests involved in this case are not. For example, there were only four limited partners. *Cf. Bamco 18*, 675 F. Supp. at 830 (stressing that a limited partnership with few limited partners is generally not a security); *Bank of America National Trust & Savings Ass'n*, 595 F. Supp. at 806-07 (E.D. Pa. 1984). Furthermore, the agreements in this case have the unique qualities arising from the "one-on-one negotiations" that generally take commercial con-

tracts out of the securities laws. *Marine Bank v. Weaver*, 455 U.S. 551, 559-60 (1982) ("We hold that this unique agreement negotiated one-on-one by the parties is not a security."); *Bank of America National Trust & Savings Ass'n*, 595 F. Supp. at 806-07. Additionally, where, as here, the limited partners have collateral contractual relationships with the venture that give an added measure of control, such authority takes their interest outside the scope of *Howey*. *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981).

2. The Promoter of a Venture Cannot Assert That His or Her Interest Is a "Security"

In *Howey*, the Supreme Court stated that a security exists only when one is induced to invest money on the promise that profits will come from the efforts of the promoter. This test clearly contemplates that the promoter himself cannot assert that his or her interest is a security, because the promoter cannot claim that he or she was "induced" into the venture by the promises of others.[4]

This Court recently examined the scope of federal securities statutes in *Reves v. Ernst & Young*, 58 U.S.L.W. 4208 (1990). The Court recognized that the key to determining whether the securities laws apply to an investment is the nature and purpose of the transaction. Recognizing the limited scope of the securities

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[4] Of course, as the Supreme Court has noted, the *Howey* analysis does not apply to more traditional investments, such as stocks and bonds, expressly listed as securities in the Act. *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). Rather, the test applies to determine whether instruments not specifically enumerated "securities" may nevertheless be characterized as such because they serve as a de facto substitute for traditional securities.

statutes, *id.*, the Court held that whether a note is a "security" depends on the purposes underlying its purchase:

> If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security."

Id. The Court intended by this test to limit the scope of the securities laws to those situations where one seeks "the use of the money of others on the promise of profits." *Id.* (quoting *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946)).

These considerations indicate that the promotor of an enterprise simply cannot claim that his retained interest in an enterprise is an "investment contract." In this case, the Plaintiff-Doctors were not victimized by someone seeking to use their money. Rather, it was the Doctors, after having already spent over $120,000 promoting the venture, who sought to induce Healthcare to part with its money on the promise that the Doctors would ensure a profit by admitting their own patients, inducing other doctors to admit patients, and developing and operating clinical programs that would keep the hospital full. The Doctors' lawsuit turns *Howey* on its head — the "investor" is in this case being sued by the very "promoters" the securities laws were intended to regulate.

3. The Court of Appeals' Decision Is Contrary to the Summary Judgment Principles Set Forth in *Celotex*

It is now established that the party bearing the burden of proof on an issue must come forward with evidence raising a fact question on every essential element of that issue in response to a

summary judgment motion. *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986). Where the party with the burden fails to do so, summary judgment should be granted. *Id.*

In *Celotex*, this Court noted:

> Summary judgment procedure is properly regarded not as a disfavored procedural shortcut, but rather as an integral part of the Federal Rules as a whole, which are designed "to secure the just, speedy and inexpensive resolution of every action." Fed. R. Civ. P. 1. . . . Rule 56 must be construed with due regard not only for the rights of persons asserting claims and defenses that are adequately based in fact . . ., but also for the rights of persons opposing such claims and defenses to demonstrate in the manner provided by the Rule, prior to trial, that the claims and defenses have no factual basis.

Id. at 327. In this case, one "essential element" on which the Plaintiff-Doctors bear the burden of proof is to show that their partnership interests in the hospital were "securities" under the *Howey* test.

This case thus presents an interesting juxtaposition of procedural and substantive rules. On the one hand, Rule 56 requires that the Plaintiff-Doctors raise a fact issue. Fed. R. Civ. P. 56; *Celotex*, 477 U.S. at 322-23. On the other hand, under *Howey*, the Doctors' interests are not securities if the Doctors did not invest money with an expectation of profits derived solely from the efforts of the promoters. *Howey*, 328 U.S. at 299. The burden under *Celotex*, therefore, was for the Plaintiff-Doctors to show that they played no substantial part in the operation or success of the enterprise. *Cf. Albanese v. Florida National Bank*, 823 F.2d 408, 410 (11th Cir. 1987) (per curiam); *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Frazier v. Manson*, 651 F.2d 1078, 1080 (5th Cir. 1981); *Martin v. T.V. Tempo, Inc.*, 628 F.2d 887, 891 (5th Cir. 1980).[7]

The analysis trial courts must employ under *Celotex* in this situation may be analogized to a measuring cup. The cup bears a line representing the threshold level of participation in and contribution to an enterprise that takes the investment outside the ambit of federal securities statutes. Once the evidence of a plaintiff's contributions exceeds this threshold, the efforts are deemed so substantial that it cannot reasonably be said that the plaintiff expected profits derived solely from the efforts of the promoter. Historically, the federal courts have held that the *Howey* threshold is not crossed if the investors' efforts may be considered to fall below the contribution line designated "menial," "nominal," or "ministerial" — i.e., where the investor's efforts have little practical effect on the profitability or success of the venture.[5] *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976). Once this threshold is crossed, however, federal courts recognize that as a matter of law no "security" exists under *Howey*. *Id.*

Where a movant has established facts showing that the plaintiff's efforts exceed the *Howey* threshold, it is not enough for the plaintiff to list other functions he or she did not perform. To

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[5] This threshold is historically a low one. Any substantial contribution by the investor takes the interest outside the scope of the statute. Hence, federal courts have often granted summary judgment in securities cases where the interest fails to meet the *Howey* test. *E.g., Marine Bank v. Weaver*, 455 U.S. 551 (1982); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, (1975); *Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988); *Meyer v. Dans un Jardin, S.A.*, 816 F.2d 533 (10th Cir. 1987); *Villenueve v. Advanced Business Concepts Corp.*, 698 F.2d 1121 (11th Cir. 1983), *aff'd en banc per curiam*, 730 F.2d 1403 (1984); *Frazier v. Manson*, 651 F.2d 1078 (5th Cir. 1981); *Crowley v. Montgomery Ward & Co.*, 570 F.2d 877 (10th Cir. 1978); *Fargo Partners v. Dain Corp.*, 540 F.2d 912 (8th Cir. 1976); *Bailey v. J.W.K. Properties, Inc.*, 703 F. Supp. 478 (W.D. Va. 1989); *Bamco 18 v. Reeves*, 675 F. Supp. 826 (S.D.N.Y. 1987); *Inforex Corp. v. MGM/UA Entertainment Co.*, 608 F. Supp. 129 (C.D. Cal. 1984).

continue the analogy, one cannot reduce excess water in the measuring cup by pointing to the remaining space. Whether the cup is "half full" or "half empty", it still contains more than the permitted measure. Similarly, no matter how many functions a plaintiff may claim he or she does not perform for a joint venture, the specific facts taking the plaintiff's efforts across the *Howey* threshold remain.

The plaintiff faced with a properly supported summary judgment motion in this context must instead confront and directly controvert the specific facts adduced by the movant. The focus is on the investor's contributions to the enterprise. Unless the plaintiff can raise a fact issue on the importance of his or her contributions to the venture, the threshold has been passed and summary judgment is appropriate. To return to the analogy, once the measure in the cup passes the "nominal" level, the plaintiff cannot rely on the remaining "empty air" in the cup; instead, he or she must remove some of the water to reduce the level below the threshold.

In this case, Healthcare submitted summary judgment proof detailing the Doctors' very substantial contributions to the venture. This proof was largely composed of the Doctors' own testimony. *See*, pp. 3-10, *supra*. The Doctors did not dispute the facts adduced in Healthcare's motion; rather, they compiled a "laundry list" of functions performed by others. As the district court correctly noted in its opinion, the focus of proof in a case such as this cannot be on what the Plaintiff-Doctors did not do; rather, the issue is whether the functions the Plaintiff-Doctors performed were sufficiently important to the hospital's success to negate the third prong of the *Howey* test. App. at A15; *see also Bailey v. J.W.K. Properties, Inc.*, 703 F. Supp. 478 (W.D. Va. 1989) (movant need not show that plaintiffs controlled "every detail" of venture, but only needed to show "significant" control). Under *Celotex*, the Plaintiff-Doctors' failure to come forward

with evidence negating the specific, documented evidence of the Plaintiffs' input into and control over critical functions and hospital profitability establishes those facts as a matter of law. It was therefore undisputed that the Plaintiff-Doctors:

1. Significantly controlled the "lifeblood" of the venture — patient admissions;

2. Controlled the Credentials Committee, which determined who could admit patients to the hospital and, therefore, who could use the hospital's services;

3. Directed the allocation of the hospital's resources by virtue of the Clinical Advisory Agreement, the Medical Directorship, and the Unit Medical Directorships, because all the beds at the hospital were committed to one or another of the clinical programs controlled by these positions;

4. Had significant control over and input into any material changes in the operations by virtue of the Clinical Advisory Agreement, which required that Appellants receive 90 days' notice of any material change in the hospital's programs; and

5. Had substantial input into and responsibility for recruiting doctors, had supervisory powers over hospital staff, had input into hiring, firing and promotion decisions, and were responsible for promoting the hospital's public image through lectures and appearances.

By no stretch of the English language could these contributions be considered nominal or unimportant. Thus, the Plaintiffs failed to carry their burden under *Howey* to raise a fact issue as to whether they expected profits derived "solely" from the efforts of others, and the trial court properly granted summary judgment.

II. The Court of Appeals' Decision Conflicts with Other Federal Courts' Holdings

1. Other Federal Courts Recognize That an Investor Who Contributes Substantially to the Success of a Partnership May Not Assert Securities Claims

The Court of Appeals held in this case that the essential test for whether a partnership interest may be considered a security is whether the investor's contributions are "managerial." In so holding, it declined to examine the impact the Plaintiff-Doctors' efforts had on the overall success and profitability of the partnership's sole asset, West Oaks Hospital. The Fifth Circuit's failure to undertake that analysis is contrary to the test applied by other federal courts in dealing with this issue.

Under *Howey*, the touchstone of an "investment contract" is an expectation of "*profits* derived solely from the efforts of the promoter. . . ." 328 U.S. at 299 (emphasis added). In applying the *Howey* test, other federal courts have recognized that "an investor who has the ability to control the profitability of his investment, either by his own efforts or by majority vote in group ventures, is not dependent upon the managerial skills of others." *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *see also Albanese v. Florida National Bank*, 823 F.2d 408, 410 (11th Cir. 1987) (per curiam); *Martin v. T.V. Tempo, Inc.*, 628 F.2d 887, 891 (5th Cir. 1980); *Bender v. Continental Towers Limited Partnership*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986). As the *Bender* court noted in applying the *Howey* test:

> "In each case [in which there was a security], without the efforts of the promoters, the investment would be worthless."

Id. at 501.

In *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981), the Fifth Circuit undertook a thoughtful

analysis of the application of *Howey* to partnership interests, holding:

> [M]eaningful powers possessed by joint venturers under a joint venture agreement do indeed preclude a finding that joint venture interests are securities.

Id. at 425. The court enumerated four specific, limited exceptions to this rule, each predicated on a finding that, despite the potential existence of meaningful powers in the partners, unique facts created a "genuine dependence" by the partners on the expertise of the promoters. *Id.* at 422-23. As the court noted:

> If, for example, the partner has irrevocably delegated his powers, or is incapable of exercising them, or is so dependent upon the particular expertise of the promoter or manager that he has no reasonable alternative to reliance on that person, then his partnership powers may be inadequate to protect him from the dependence on others which is implicit in an investment contract.

Id. at 422-23.

In this case, there is no dispute that the Doctors possessed "meaningful powers" — they admitted their substantial participation in the venture and critical contributions to its success at length in their depositions. Nor can there be any issue regarding "genuine dependence," because the Doctors admitted that they (1) had almost concluded a contract with an alternate management company prior to engaging Healthcare; (2) negotiated to purchase the venture from Healthcare prior to selling their interests; and (3) built and operated a competing hospital after selling their interests. Thus, Healthcare possessed no unique or irreplaceable skills that would negate the Doctors' influence or render them powerless.

The Plaintiff-Doctors were, by their own admission, the "rainmakers" of the venture, and enjoyed the influence and power that go with such a position. Their decisions as clinical directors

were vital to the operation of the venture. So long as the Plaintiff-Doctors admitted their patients and served as directors of the hospital's programs, West Oaks would be a success regardless of who "managed" the venture. When the Doctors removed their patients, the hospital immediately began to suffer. *Cf. Martin v. T.V. Tempo, Inc.*, 628 F.2d 887 (5th Cir. 1980) (franchisee's efforts in locating advertisers were critical to profitability; hence, no security existed). Their own sworn testimony leaves the Doctors no room now to disavow their substantial contribution to the venture's success.

2. Other Federal Courts Have Rejected the "Managerial Efforts" Test Adopted by the Court of Appeals

Parties have attempted before now to distinguish their contributions to a business venture from "managerial" efforts so as to bring their investments within the scope of *Howey*. Given the difficulties inherent in applying such an illusory test, it is not surprising that every other federal court to examine the distinction has rejected it. *See Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989); *Inforex Corp. v. MGM/UA Entertainment Co.*, 608 F. Supp. 129 (C.D. Cal. 1984); *Slevin v. Pedersen Associates, Inc.*, 540 F. Supp. 437, 441 (S.D.N.Y. 1982).

In *Maritan*, the plaintiff had invested in a real estate venture. The parties' contract vested "managerial" responsibility with the defendant, although the plaintiff in fact had input into or approved several transactions. 875 F.2d at 1455-56 (listing examples). Like the Doctors, Maritan sought to argue that his efforts were not "managerial" and hence were not relevant for purposes of applying *Howey*. *Id.* at 1456-57: "[Maritan's] approach to the case focuses mainly on the distribution and exercise of managerial responsibility for this project." *Id.* at 1457. The Tenth Circuit rejected reliance on talismanic terms such as "managerial," and

instead examined the substance of the transaction in light of the *Howey* test:

> Whether or not exercised, Maritan's access to critical information about the venture, his power under the agreement, *and his demonstrated active involvement* gave him sufficient control over the ultimate expectation of profits so that the third prong of the *Howey* test, as defined in this circuit, is inapplicable as a matter of law.

Id. at 1459 (emphasis added).

In *Inforex*, the district court expressly rejected the "managerial efforts" test proferred by the Plaintiff-Doctors and made the basis for the Court of Appeals' decision. In *Inforex*, plaintiff was the assignee of the interest of Sean Connery in residual payments under a contract he entered into as part of his compensation for playing British superspy James Bond in a series of highly successful films. He later claimed that his interest in the films was a "security", arguing that although he made substantial efforts toward the venture's success, "managerial" control was vested in others. The court rejected the distinction:

> Plaintiff, while conceding that the complaint alleges that Sean Connery played the role of James Bond in the particular James Bond films at issue here, nevertheless attempts to distinguish this significant acting effort from the managerial efforts emphasized by *Howey* and its progeny. . . . In this case, alleging that Sean Connery agreed to play and did play James Bond in the relevant films establishes that he had an undeniably significant role in the venture. . . . Plaintiff has set forth no argument, and the court has found none, that would require that the efforts must be "managerial" unless that term is broadly defined to include any active participation directed toward securing the profitability of the venture.

608 F. Supp. at 133.

The decisions of the courts rejecting the "managerial efforts" test comports both with this Court's holding in *Howey* and with

later cases stating that an investor must expect his profits to come from the efforts of others. Courts have held, for example, that an expectation of profits derived from appreciation in property values does not meet this test. *Grenader v. Spitz*, 537 F.2d 612, 619 (2d Cir.), *cert. denied*, 429 U.S. 1009 (1976); *Bender v. Continental Towers Limited Partnership*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986) (no security where investors "were simply drawn in by an expectation of appreciation."). This is because the expectation of profits does not depend upon "the efforts of the promoter or other third party," *id.* at 501, but rather on the impersonal workings of the marketplace for real estate. *Grenader*, 537 F.2d at 619. The efforts of the Plaintiff-Doctors in this case far exceed those of the investors in cases such as *Maritan* and *Inforex*. In each of those cases, the courts held that no security existed as a matter of law. Petitioners respectfully submit that the Court of Appeals' decision conflicts with those holdings.

3. The Court of Appeals' Decision Conflicts with the "Undeniably Significant Efforts" Test Utilized by Other Federal Courts

The test applied by the Court of Appeals represents a fundamental departure from the analysis utilized by other federal courts in applying the third prong of *Howey*.

In reaching its decision, the Court of Appeals noted the trial court's conclusion that the undisputed summary judgment facts showed "that the Plaintiffs were actively involved in the hospital, contributed to its profitability and were crucial to its success." App. at A5; 894 F.2d at 152. The Court of Appeals held that such a showing was not enough, however. Rather, it held that unless Plaintiffs' efforts were "managerial," they were not relevant. *Id.*

The Court of Appeals' holding conflicts with the test applied by virtually every other federal court to examine the third prong of

Howey. On its face, the *Howey* analysis suggests that, where a party claims that an interest is an "investment contract", the plaintiff's expectation of profits must hinge on the efforts of the promoter or some other third party. Thus, where market appreciation is expected to provide the investor's return, no security exists, even if the investor retains no authority at all. *Dumbarton Condominium Ass'n v. 3120 R Street Associates Limited Partnership*, 657 F. Supp. 226 (D.D.C. 1987). As the court pointed out in *Bender*, in the cases finding real estate interests to be a security, "[w]ithout the efforts of the promoters, the investments would be virtually worthless." 632 F. Supp. at 501.

Generally, federal courts applying the third prong of *Howey* have granted summary judgment where the evidence showed that the investors' efforts were more than "menial" or "nominal." The test generally applied is perhaps best stated in *Bailey v. J.W.K. Properties, Inc.*, 703 F. Supp. 478, 480 (W.D. Va. 1989):

> [t]he issue is not whether plaintiffs controlled every detail of the breeding program, but *whether the plaintiffs had a significant degree of control* as opposed to an arrangement "where the investors' duties were nominal and insignificant, their roles were perfunctory or ministerial, or they lacked any real control over the operation of the enterprise."

Id. at 480 (emphasis added) (quoting *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976)). This "significant efforts" test has been echoed consistently by federal courts in applying *Howey*. *E.g., Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 (4th Cir. 1988) ("General partnership interests ordinarily are not considered investment contracts because they grant the partners — the investors — control over *significant decisions* of the enterprise.") (Powell, J.) (emphasis added); *Meyer v. Dans un Jardin, S.A.*, 816 F.2d 533, 535 (10th Cir. 1987) (rejecting franchisee's securities claim because "the typical franchisee [does not] expect to profit from

the investment without regard to the franchisee's own business skills"); *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1570 (9th Cir. 1987) (oil and gas interest not security because purchaser retained "significant managerial powers"); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir.) ("An investment contract or interest may still be a security even if the investor is required to perform some duties, *as long as those duties are 'nominal or limited and would have little direct effect upon receipt by the participants of the benefits promised by the promoters'* ") (emphasis added; quoting *Lino v. City Investing Co.*, 487 F.2d 689, 692 (3d Cir. 1973)), *cert. denied*, 469 U.S. 831 (1986); *Villenueve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1125 (11th Cir. 1983) (interest not an investment contract where investors were required to "make *substantial efforts* toward the profit") (emphasis added), *aff'd en banc per curiam*, 730 F.2d 212, 215 (6th Cir. 1983) (partnership interest held to be security only where "the functions the 'investor' performs are not significant managerial ones, but mere ministerial ones"); *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982) ("[A]rrangements which grant the investors control over the significant decisions of the enterprise are not securities."), *cert. denied*, 429 U.S. 1009 (1976); *Williamson v. Tucker*, 645 F.2d 404, 425 (5th Cir.) (possession by investor of "meaningful powers" precludes finding interests are securities as a matter of law), *cert. denied*, 454 U.S. 897 (1981); *Crowley v. Montgomery Ward & Co.*, 570 F.2d 877, 880-81 (10th Cir. 1978). The facts adduced in this case bring it squarely within the court's analysis in *Crowley*:

> It is undisputed that the franchisees contributed both time and effort to the success of the common enterprise. . . . The contribution of time and effort is only a part of the test. Consideration must be given to control over the factors essential to the success of the enterprise. Affidavits submitted by Plaintiffs contain only conclusory allegations that Montgomery Ward controlled success.

> . . . The conclusory allegations in plaintiffs' affidavits contain no facts showing that the factors controlled by Montgomery Ward are critical to the success of the enterprise. *The undisputed facts are that the franchisees had, and exercised, effective and important control over that success. The economic reality is that the contributions of the franchisees significantly and substantially affect the profits* expected from the enterprise. The agency agreement is not a security. . . .

Id. at 880-81 (emphasis added). In this case, despite undisputed summary judgment evidence showing that the Doctors exercised "effective and important control" over the success of the partnership, the Fifth Circuit found that such control was immaterial because, in the eyes of the court, the Doctors' contributions were not "managerial". That holding is in irreconcilable conflict with *Howey* and its progeny.

CONCLUSION

The decision of the Court of Appeals in this case conflicts directly with that of other federal courts and effectively dispenses with the third and most important prong of the *Howey* test. By adopting a talismanic test for the third prong of *Howey* — whether the efforts were "managerial" or not — the Court of Appeals ignored this Court's long-standing rule that in applying *Howey* the courts are to be guided by the "economic reality" of the transaction. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The Court should grant certiorari in order to insure consistent application of federal securities laws.

Respectfully submitted,

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APPENDIX

APPENDIX: TABLE OF CONTENTS

		PAGE
1.	Court of Appeals' Opinion	A1
2.	District Court's Final Judgment	A9
3.	District Court's Opinion	A10

APPENDIX A

No. 89-2236

United States Court of Appeals

FIFTH CIRCUIT.

FEB. 12, 1990

L & B HOSPITAL VENTURES, INC., LEO J. BORRELL, BOBBY R. LOWRANCE, PSYCHIATRIC ASSOCIATES OF HOUSTON, P.A., AND DOUGLAS B. HANSEN,
Plaintiffs-Appellants,

v.

HEALTHCARE INTERNATIONAL, INC., WEST OAKS, INC., HEALTHCARE-BROWN MANAGEMENT CO., THE BROWN SCHOOLS, INC., JAMES L. FARISS, JR., DAVID L. WHELAN AND ELLIOTT H. WEIR, JR.,
Defendants-Appellees.

Appeal from the United States District Court for the Southern District of Texas.

Before DAVIS and SMITH, Circuit Judges, and LITTLE, District Judge.[1]

LITTLE, District Judge:

Believing they were bamboozled by the vendee-defendants, vendor-plaintiffs filed suit asserting, among other causes of action, relief under the Securities Exchange Act of 1934. 15 U.S.C. § 78j. The properties which the plaintiffs owned and sold were limited partnership interests in West Oaks, The Psychiatric Institute of Houston, Ltd. The purchaser was the general partner.

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[1] District Judge of the Western District of Louisiana, sitting by designation.

The defendants presented a very narrow issue in their motion for summary judgment. Stripped to its bare essentials, the motion asserts that there is no securities violation as that which was sold and purchased was not a security. The sellers were so inextricably intertwined in the partnership that they are not afforded the protection of the Securities Act. The trial court determined that there was no genuine issue of material fact and granted the defendants' motion, dismissed the plaintiffs' case with prejudice and dismissed the pendent state law claims without prejudice. Plaintiffs' appealed that decision. We REVERSE.

Four physicians, each having a specialty in psychiatry, recognized a need for an inpatient treatment facility for adolescents and children in the Houston area (Tr. 779). The development of the project was discussed with plaintiffs by defendant James L. Fariss, Jr., an employee of co-defendant Brown Schools, Inc. A limited partnership agreement formed under the laws of Texas was signed in September of 1979; the limited partners were three psychiatrists (Hansen, Borrell and Lowrance) and one medical corporation (Psychiatric Associates of Houston, P.A.) whose members specialized in psychiatry. Each limited partner had a 6¼% interest in the partnership. The general partner was Brown Schools, Inc. which owned the remaining 75% interest. According to the physicians, Brown Schools, Inc. had expertise in hospital construction, management and operation.

The nature of the impasse between the limited partners and the general partner is not material to this discussion. We need only observe that some discontent with the investment was the motivating force for plaintiffs to sell their limited partnership interests to the general partner, one of the defendants. The discontent burgeoned into allegations of fraud and deception when the plaintiffs discovered certain post-sale facts which are the basis of their complaint against the defendants.

The standard of review which we follow is summarized in *Jones* v. *Southern Marine & Aviation Underwriters*, 888 F.2d 358, 360 (5th Cir.1989). The standard of review at the appellate level of a district court's grant or denial of summary judgment remains the same as at the trial court level. *Ayo* v. *Johns-Manville Sales Corp.*, 771 F.2d 902, 904 (5th Cir.1985). For summary judgment to be granted, the pleadings, depositions, answers to interrogatories, and admissions on file, together with any affidavits, must demonstrate that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. *Id.*; Fed R.Civ.P. 56(c). *See also Celotex Corp.* v. *Catrett*, 477 U.S. 317, 322-24, 106 S.Ct. 2548, 2552-53, 91 L.Ed.2d 265 (1986). Under this standard fact questions are considered with deference to the non-movant. *Reid* v. *State Farm Mut. Auto Ins. Co.*, 784 F.2d 577, 578 (5th Cir.1986). The appellate court decides questions of law, however, just as it decides questions of law outside the summary judgment context: *de novo*. *Walker* v. *Sears, Roebuck & Co.*, 853 F.2d 355, 358 (5th Cir. 1988); *Brooks, Tarlton, Gilbert, Douglas & Kressler* v. *United States Fire Ins. Co.*, 832 F.2d 1358, 1364 (5th Cir.1987).

The oft cited *Celotex*, interpreting Rule 56 of the Federal Rules of Civil Procedure, requires the entry of a summary judgment against the party failing to make a showing sufficient to establish the existence of an element essential to that party's case. *Celotex*, 477 U.S. at 322-24, 106 S.Ct. at 2552-53. In this case, the defendants claim that the plaintiffs do not belong to the class of investors to whom the Securities Act offers protection. There is no disagreement that the Securities Act applies to investment contracts and that, generally, investment contracts include limited partnership interests. *Williamson* v. *Tucker*, 645 F.2d 404, 423-24 (5th Cir.), *cert. denied*, 454 U.S. 897, 102 S.Ct. 396, 7 L.Ed.2d 212 (1981). The Supreme Court crafted a definition of investment contract which forms the starting point for our analysis. In *S.E.C.* v. *W. J. Howey Co.*, 328 U.S. 293, 298-99, 66 S.Ct.

1100, 90 L.Ed. 1244 (1946), an investment contract was defined as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." More recently, however, the Supreme Court has modified the definition of investment contract. In *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852, 95 S.Ct. 2051, 2060, 44 L.Ed.2d 621, 632 (1975), the Supreme Court defined or restated investment contract as "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or management efforts of others." This circuit has provided additional guidance in light of *Howey* and *United Housing Foundation* directing the benefits of the statute to investors in entities where the " *'efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise'* " (emphasis supplied). *Williamson*, 645 F.2d at 418 (quoting with approval *Securities and Exchange Commission* v. *Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821, 94 S.Ct. 117, 38 L.Ed.2d 53 (1973)); *see also Long* v. *Shultz Cattle Co.*, 881 F.2d 129, 133 (5th Cir. 1989); *Securities & Exchange Commission* v. *Koskot, Inc.*, 497 F.2d 473, 483 (5th Cir.1974).

In ruling in defendants' favor, the trial court found as undisputed facts that the plaintiffs were actively involved in the hospital, contributed to its profitability and were crucial to its success. But the opinion recognizes that the medical acumen of the physicians was not the sole profit generating power unit. The thing needed a head, an operational manager, hence the general partner. The plaintiff limited partners had professional or clinical control but the defendants had managerial control. The trial court equated the professional medical involvement of the plaintiffs and their rights to perform as medical men with being

"significant" within the *Williamson* case, *Williamson*, 645 F.2d at 422. The trial court concluded that:

> The plaintiffs have failed to "designate specific facts showing that there is a genuine issue for trial" and defendants are entitled to judgment as a matter of law.

(Tr. 10). The *Williamson* case analyzed and classified the purchase of joint venture interests in a real estate holding enterprise in Texas. The plaintiffs claimed their interests were investment contracts and that the Securities Acts of 1933 and 1934 gave them status to file a federal suit. The defendants claim that the meaningful powers possessed by the plaintiffs under the joint venture agreements precluded a finding that the joint venture investments were investment contracts.

In the lengthy and thoughtful opinion authored by Judge King, the following language sheds light on the law:

> So long as the investor retains ultimate control, he has the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the manager. It is not enough, therefore, that partners in fact rely on others for the management of their investment; a partnership can be an investment contract only when the partners are so dependent on a particular manager that they cannot replace him or otherwise exercise ultimate control.

Williamson, 645 F.2d at 424. In this area of the law, the key is *managerial efforts*. In that connection the plaintiffs presented deposition evidence that they did not have nor in fact employ managerial capacity but were dependent upon the managerial activities exerted by the general partner. The evidence from the plaintiffs included the following:

> 1. The limited partnership agreement between Brown Schools, Inc. (a subsidiary of defendant Healthcare International, Inc.) as general partner and physician plaintiffs, Douglas B. Hansen, Leo J. Borrell, Bobby R. Lowrance,

Psychiatric Associates of Houston, as limited partners. That agreement sets forth the strictures on the limited partners' powers. That agreement, in part, provides that the limited partners do not have the capacity to participate in the management or control of the partnership nor are they capacitated to transact any business for the partnership. When it comes to management, ultimate and sole control is in the province of the general partner. The agreement also provides that the general partner has the exclusive authority to manage the operation and affairs of the partnership and to make all decisions regarding the business of the partnership, including determination of cash reserves, cash distributions, leasing of property, selling of property or refinancing (Tr. 550).

2. Testimony of Leo J. Borrell that the defendants wanted to make sure that the plaintiffs remained limited partners and would not be involved in day-to-day operations. In fact, according to Borrell, the limited partners were informed by the general partners that the limited partners neither had the right nor the obligation, nor would they be allowed by the general partners, to participate in the hospital's day-to-day operations (Tr. 512).

3. Testimony of Bobby R. Lowrance that, as a limited partner, he exercised no control over managerial decisions, expenses, capital expenditures, debt acquisition or payment, hiring or firing, nor did he have any control over access to the business or financial information concerning the operation of the partnership. The limited partner was dependent upon the managerial and financial expertise of the defendant Healthcare and only provided influence on patient care matters (Tr. 548-49).

4. Testimony of Douglas B. Hansen that the managerial control of the partnership was undertaken by the general partner to the exclusion of the limited partners (Tr. 274-78).

5. The Management Agreement dated 29 September 1979 between the general partner and the manager wherein all the specific operational duties are described (Tr. 588-613).

6. A table of responsibility for hospital admissions for years 1982-1985. That table reveals the percentage of admissions for

which each limited partner (plaintiff, excluding Douglas Hansen) was responsible. The figures could be read to reveal a rather meager contribution of patients to the total pool of admittees (Tr. 32).

7. Testimony of Kay E. Peck, Administrator of the West Oaks Hospital, that she ran the hospital; that she and a vice president for defendant Healthcare handled the operations of the hospital, Healthcare being the general partner, which included contract matters, financial affairs, labor relations and employment fringe benefits. Basically, all administrative duties were handled through her as the designee of the general partner.

In our opinion, there is evidence that plaintiffs never exerted nor had capacity to exert essential managerial efforts. There is evidence that essential managerial efforts of the entity were undertaken in fact and by contract by the defendants. Our findings that the plaintiffs have established specific facts showing a genuine issue for trial should not be interpreted as a finding in favor of the plaintiffs. All that we intended is to demonstrate that upon the documentation presented by the plaintiffs and in the light of existing law, the summary judgment should not have been granted. Accordingly, the judgment is REVERSED and the matter REMANDED.

IN THE

United States District Court

FOR THE
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

L&B HOSPITAL VENTURES, INC., et al.,
Plaintiffs,

vs.

HEALTHCARE INTERNATIONAL, INC. et al.,
Defendants.

CIVIL ACTION NO. H-88-1077

FINAL JUDGMENT

This Court having granted Defendants' motion for summary judgment, this case is hereby DISMISSED with prejudice. The pendant state law claims are dismissed without prejudice.

This is a FINAL JUDGMENT.

Signed this 2nd day of February, 1989 at Houston, Texas.

NORMAN W. BLACK
United States District Judge

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ORDER

Pending before the Court are Defendants' motion for summary judgment, counterclaim and third-party Defendants' motion for summary judgment and Plaintiffs' motion for partial summary judgment. For the reasons set forth below the Court is of the opinion Defendants' motion should be granted and the other motions denied.

In 1976 or 1977 Plaintiffs Borrell, Lowrance and Hansen along with a Dr. McReynolds decided to develop a new psychiatric hospital where they would admit their patients. In June of 1979 Plaintiffs reached an agreement with Brown Schools, Inc. (Brown), now a subsidiary of Defendant Healthcare International, Inc., whereby Plaintiffs would own 25% of the project and Brown 75% pursuant to a limited partnership agreement. Brown was to provide administrative services and arrange for financing the construction of the hospital. The Psychiatric Institute of Houston, a limited partnership, was formed in September of 1979.

This suit arises out of the Defendants' purchase of Plaintiffs' limited partnership interests in the hospital. Plaintiffs have alleged statutory and common law fraud, breach of fiduciary duty, breach of contract and deceptive trade practices. Federal jurisdiction is based on violations of the Securities Exchange Act of 1934.

To assert securities fraud a Plaintiff must plead and establish fraud in connection with the purchase or sale of a security. Defendants contend in their motion for summary judgment that this case should be dismissed because the limited partnership interests at issue are not securities as defined in the federal securities laws. The sole issue to the decided by the court at this time is whether Plaintiffs' limited partnership interest was an investment contract thus making it a security.

The Securities and Exchange Act, § 3(a)(10), 15 U.S.C. § 78c(a)(10) lists numerous instruments considered to be securities. The term securities has been interpreted broadly and the investment contract has been used to bring "instruments of 'more variable character' within the scope of the federal securities laws." *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 686 (1985) (citations omitted). "'[I]nvestment contracts,' *may* encompass limited partnership interests." *Frazier* v. *Manson*, 651 F.2d 1078, 1080 (5th cir. 1981) (emphasis added). However, the "Supreme Court has repeatedly emphasized that economic reality is to govern over form and the definitions of the various types of securities should not hinge on exact and literal tests. *Williamson* v. *Tucker*, 645 F.2d 404, 418 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

The test for what constitutes an investment contract is found in *S.E.C.* v. *W. J. Howey Co.*, 328 U.S. 293 (1946) which holds that an investment contract is "a contract, transaction or scheme whereby a person invests his money in common enterprise and is led to expect profits solely from the efforts of the promoter or a

third party." *Id.* at 298-99. For the purposes of this case it is only necessary to focus on one element of the *Howey* test: did the Plaintiffs expect profits solely from the efforts of others?

Since *Howey*, the Fifth Circuit has concluded that a literal application of the word "solely" is unwarranted and it should be interpreted in a more flexible manner. *SEC* v. *Koscot Interplanetary, Inc.*, 497 F.2d 473, 480 (5th Cir. 1974). Presently, the appropriate inquiry is whether "the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *Williamson*, 645 F.2d at 418.

Federal securities laws "were not intended to provide a federal remedy for all fraud or misconduct arising out of commercial transactions" *Youmans* v. *Simon*, 791 F.2d 341, 346 (5th Cir. 1986) *citing Marine Bank* v. *Weaver*, 455 U.S. 551, 556 (1982). "Agreements negotiated one-on-one creating enterprises in which investors are actively involved, knowledgable, and able to protect their interests are not within the ambit of the federal securities laws. *Id.* As a result an "investor who has the ability to control the profitability of his investment, . . . is not dependent upon the managerial skills of others. Thus . . . arrangements which grant the investors control over the significant decisions of the enterprise are not securities." *Gordon* v. *Terry*, 684 F.2d 736, 741 (5th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983). In addition, when an investor has partial control of an enterprise he does not always need the extensive protection of the federal securities laws. *Fraizer* v. *Manson*, 651 F.2d 1078, 1088 (5th Cir. Unit A 1981). The key issue is whether the managerial efforts are functionally essential or undeniably significant to make a profit. *Cameron* v. *Outdoor Resorts of America, Inc.*, 608 F.2d 187, 193 (5th Cir. 1979), *modified on rehearing on other grounds*, 611 F.2d 105 (1980).

Summary judgment is authorized if there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law.. Rule 56, Fed. R. Civ. P. The United States Supreme Court has interpreted this rule to mandate the entry of summary judgment after an adequate time for discovery against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial. *Celotex Corp.* v. *Catrett*, 477 U.S. 317 (1986).

In reviewing a motion for summary judgment, this Court must determine whether the undisputed facts, considered in the light most favorable to the party opposing the motion, establish that the moving party is entitled to judgment as a matter of law. *Adickes* v. *S. H. Kress & Co.*, 398 U.S. 144 (1970). Although Plaintiffs believe otherwise, summary judgment is "not a disfavored procedural shortcut, . . . [and] designed 'to secure the just, speedy an inexpensive determination of any action'." *Celotex* at 2555 (quoting Rule 1, Fed. R. Civ. P.). It is mandatory that a Court grant a well-supported motion when the nonmovant does not adequately defend against it. *Mosby* v. *American Medical International, Inc.*, 656 F.Supp. 601, 605 (S.D. Tex. 1987).

Defendants have the burden of demonstrating there is no actual dispute as to any material fact. Here they must show that the limited partnership truly operated like a general partnership in that the limited partners actually participated in the management and control of the hospital. Once this has been done the Plaintiffs must do more than simply allege a fact issue exists. They must set forth *specific facts* showing that there is a genuine issue for trial. Rule 56(e), Fed. R. Civ. P. (emphasis added). This they have failed to do.

Contrary to Plaintiffs' argument, the Court finds that the Plaintiffs have failed to meet the requirements of *Howey* and show the limited partnership interests at issue were securities.

First of all the Plaintiffs place much weight on the fact that the parties had entered into a Limited Partnership Agreement and a Management Agreement with the Defendant. However, when one is evaluating whether something is a security "form should be disregarded for substance and the emphasis should be on economic reality." *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852 (1975). The Fifth Circiut has held that Courts must look beyond mere labels when defining a security. *Darly* v. *Morgan*, 701 F.2d 496, 499 (5th Cir. 1983).

Generally, limited partners play a passive rather than active role in their investment. Here, it is undisputed the Plaintiffs were actively involved in the hospital, contributed to its profitability and were crucial to its success. The Plaintiffs agree that a hospital is doctor driven and if doctors fail to admit patients a hospital will fail.

The pleadings and affidavits filed in this case show that the Plaintiffs were the ones who decided to build a hospital for their patients and promoted it to various investors. Borrell at 14-19, Lowrance at 48-52. The physicians wanted and needed a partner that could handle the hospital's business operations and the Defendants were to provide operational management and capital. Hansen p. 70, Lowrance p. 51-52. In addition, the limited partnership agreement gave the general partner the sole discretion to lease, sell, or refinance the property and to determine how much partnership cash to hold in reserve and how much to distribute. Plaintiffs argue that because the doctors were not involved in this type of operations their limited partnership interest was a security. The problem with this argument is that the management of this enterprise consisted of two separate components and the doctors admit they had "clinical" control over the hospital and actively participated in staff education, program design and development, personnel evaluations, the physical structural design and equipment purchases.

Plaintiff Hansen served as Medical Director. The Medical Director is responsible for overseeing the medical and clinical aspects of the hospital which includes advising the administrator on policies, administrative and employee problems and developing organizational plans. The Plaintiffs also served as Unit Medical Directors. Persons in these positions review and approve all clinical business of the hospital.

In addition, the limited partners provided services pursuant to a "Clinical Advisory Agreement" which had the power to approve all new clinical and therapy programs, hire and fire the medical director and control who practiced at the hospital. Plaintiffs also provided services under the Children's Programs Clinical Agreement. Finally, the limited partners served on the Hospital Credentials Committee and Continuing Education Committee.

According to the deposition of Dr. McReynolds, 75-90% of the initial revenue was derived from the limited partners' patients. In addition he admitted that while he was a partner 50-65% of all patients admitted were provided by the Plaintiffs. Significant contributions by the doctors to the hospital's success are also presented in the depositions of Plaintiffs Borrell and Lowrance. Borrell at 52, 62-66, 192-93, 215. Lowrance at 72-81.

The Fifth Circuit has made it clear that if an investor's rights are "significant," the interest is not a security. *Williamson* 645 F.2d at 422. "Limited partnership interests are generally held to be securities interests because the limited partners have no voice in management decisions." *Gordon* v. *Terry*, 684 F.2d 736, 741 n.5 (11th Cir. 1982). However the cases clearly show that the focus should be on what degree of influence and control the limited partners possessed rather than on what functions they did not control.

Based on the above, the Court finds the Plaintiffs played a significant role in the overall success or failure of the venture. The Plaintiffs have failed to "designate 'specific facts showing

that there is a genuine issue for trial.'" and Defendants are entitled to judgment as a matter of law. *Celotex supra.* The record shows this is simply a state law partnership dispute.

As to the pendant state claims, this Court chooses to exercise its discretion not to hear these claims since the sole federal claim is being dismissed. *United Mine Workers* v. *Gibbs,* 383 U.S. 715, 726 (1966). This dispute belongs in the state court system. As a result the Plaintiff's partial motion for summary judgment as to liability and counterclaim and third party's motion for summary judgment are denied without prejudice. Accordingly, it is

ORDERED that Defendants' motion for summary judgment is GRANTED. It is further

ORDERED that Plaintiffs' partial summary judgment as to liability is DENIED. It is further

ORDERED that countclaim and third-party Defendants' motion for summary judgment is DENIED.

Signed this 2nd day of February, 1989 at Houston, Texas.

NORMAN W. BLACK

Norman W. Black
United States District Judge